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DIRECTORATE OF INTELLIGENCE

Intelligence Memorandum

Venezuela: Progress Of Economic Diversification

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CENTRAL INTELLIGENCE AGENCY
Directorate of Intelligence
April 1971

INTELLIGENCE MEMORANDUM

Venezuela: Progress Of Economic Diversification

Introduction

1. Petroleum development has provided the decisive impetus for Venezuelan economic growth for several decades, but government officials have long recognized the dangers of excessive dependence on it. With the marked slowing of oil exploitation and economic growth after 1957, diversification gained added urgency. So far, Venezuela has been much more successful in reducing import needs than in broadening exports. Since the earlier pace of oil development probably cannot be restored, broadening the economic base remains a highly important, long-term task of economic policy. This memorandum examines the benefits and vulnerabilities arising from the oil industry's dominance, efforts to diversify the economy in the 1960s, and prospects for accelerated growth during the next several years.

Discussion

Benefits of the Oil Boom

2. Venezuela's petroleum industry grew rapidly after the first major discovery in Lake Maracaibo in 1922, and in 1943 the government and the oil companies decided to accelerate production. Rapid

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growth continued during 1946-57, when output rose an average of 9% annually. At the decade's end, the sector accounted for 92% of export earnings, some 61% of government revenues, and 29% of gross domestic product (GDP). Oil exploitation and the start of large-scale iron ore exports helped to generate increases in GDP averaging an impressive 8% annually in 1951-59 -- the highest rate in Latin America. These gains raised real per capita product by about 44% despite population growth of almost 4% annually. With an estimated GDP per capita of $820 (on a purchasing power parity basis) by 1959, Venezuela ranked third in Latin America, behind Argentina and Uruguay.

3. Large and growing petroleum earnings enabled Venezuela to avoid the chronic fiscal and balance-of-payments problems experienced by many other Latin American countries. Sizable trade surpluses and capital inflows to finance petroleum and iron ore projects boosted net foreign exchange reserves from $342 million in 1950 to a peak of $1.4 billion (Latin America's highest figure) in 1957. At the same time, the petroleum industry provided rapidly growing revenues to finance public services and investment. Government investment, which represented nearly 50% of fixed capital formation during 1950-59, was concentrated in transportation, communications, and, to a lesser extent, manufacturing and agriculture. Some outlays also were made for urban improvements such as water and sewer systems and public housing -- especially in Caracas. However, not all of the money was well spent. Some projects were poorly planned or executed, and substantial sums were used for such things as luxury hotels, military clubs, and the Caracas race track.

Need for Diversification

4. With the benefits of oil development came shortcomings and dangers as well. Much of the resulting prosperity was confined to Caracas and the oil producing regions. Regional development and other programs for income redistribution received scant attention, and many people continued to live near the subsistence level. With a population of 7 million people by 1959, Venezuela had an estimated effective consumer market of only 2½ million. Also worrisome was the economy's vulnerability to any

slowdown in exploiting petroleum resources. The sector's considerable influence on general economic activity was demonstrated in 1958-61, following settlement of the 1956 Suez crisis. As the revenue windfalls arising from that crisis disappeared and competition from new, low-cost producers in Africa intensified, Venezuelan oil exports and economic growth rates weakened markedly (see Figure 1).

5. Large petroleum revenues nevertheless had made it easy for Venezuela to ignore questions of economic diversification for some time. Because import capacity doubled between 1950 and 1959, import substitution was not promoted as strongly as in various other countries. Manufacturing output grew more rapidly than oil output during 1951-59 but still reached only 12% of GDP, or less than half of the oil sector's share. Per capita output in manufacturing remained relatively low; production consisted largely of nondurable consumer goods. Agricultural output slipped from 8% to 6% of GDP, and although commercial farm output grew steadily, it did not keep up with urban demand. Imports of farm products consequently jumped from $74 million to $208 million between 1950 and 1959.

A Decade's Progress in Broadening the Economy

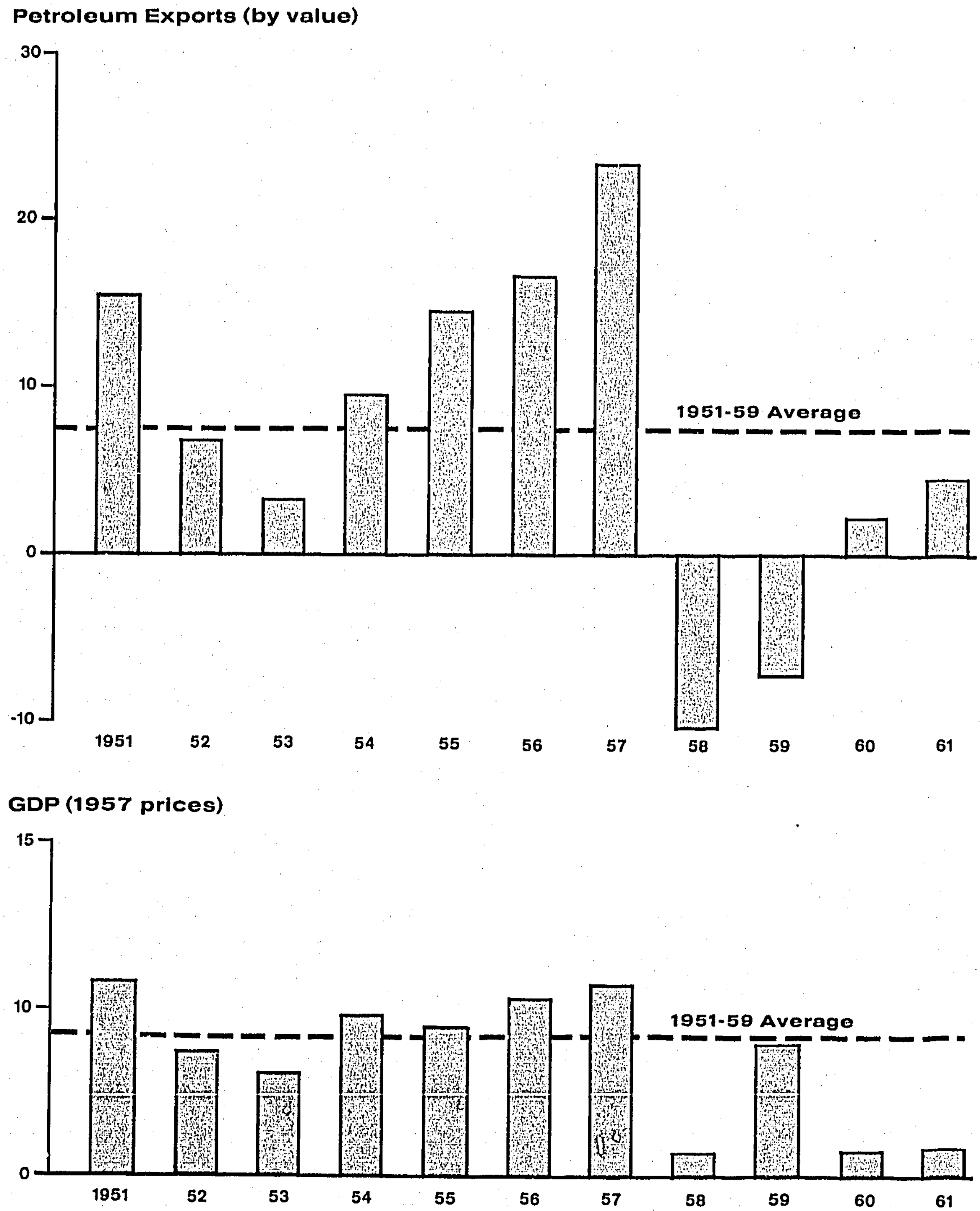
6. In response to sluggish petroleum development, Venezuelan administrations devoted considerable attention in the 1960s to diversifying and otherwise expanding output in both manufacturing and agriculture. The government committed substantial investment resources to improve transportation and communication facilities, expand electric power capacity, develop steel and petrochemical industries, and support land colonization. Public investment increased an average of nearly 15% annually in real terms during 1963-69, rising from 27% to 38% of total capital outlays. In addition, various measures were taken to stimulate private investment.

Industrial Development and Import Substitution

7. The Betancourt government (1959-63) established several large state enterprises that, together with previously established agencies, have carried out or directed industrial diversification programs. Among the most important agencies are the Venezuelan

Venezuela: Percent Change in Petroleum Exports and GDP

Figure 1



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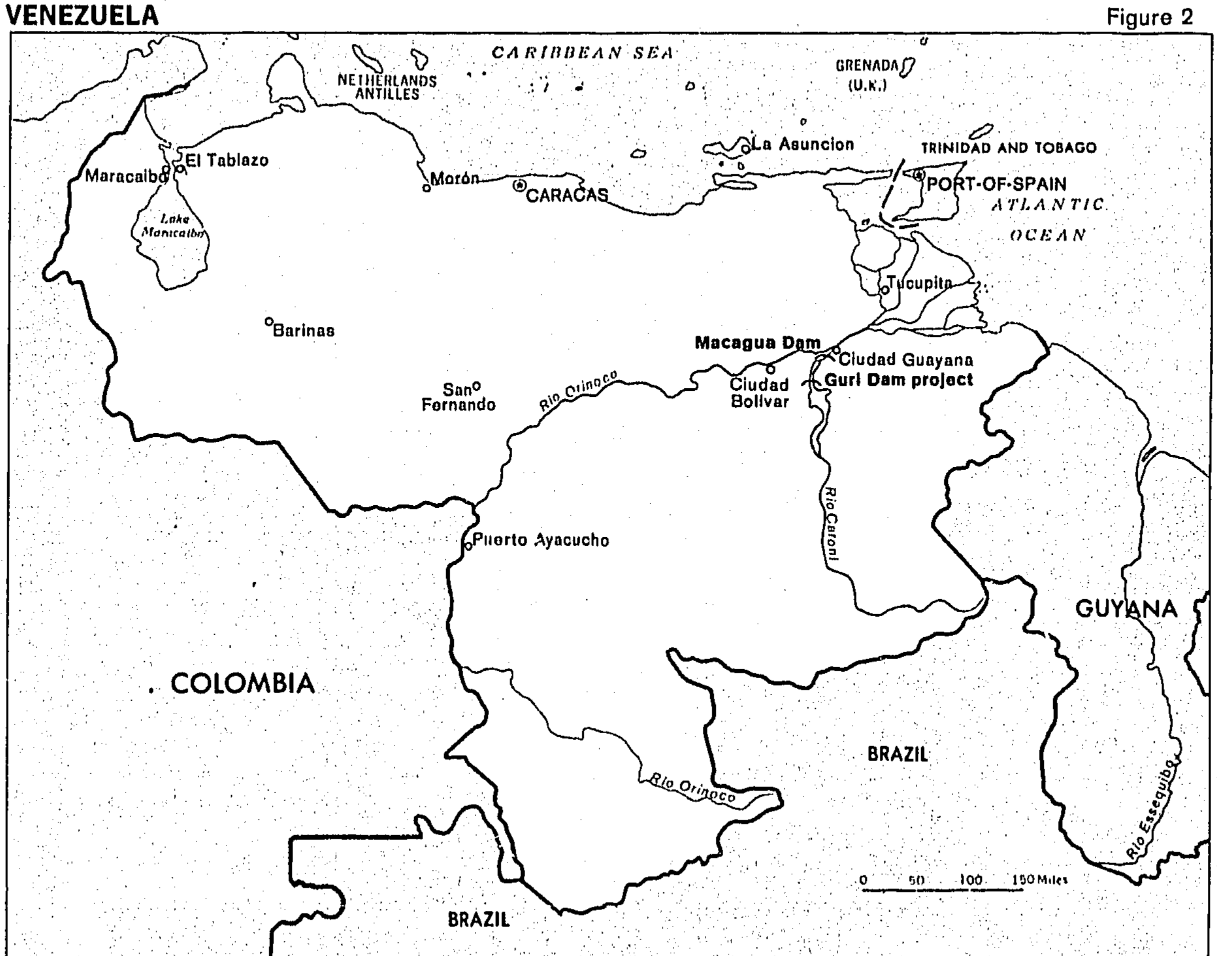
Petrochemical Institute (IVP), the Venezuelan Guayana Corporation (CVG), the Venezuelan Development Corporation (CVF), and the Electric Power Administration and Development Corporation (CADAFE). Exploitation of hydroelectric resources took a large step forward with completion in 1961 of the Macagua Dam on the Caroni River, at its confluence with the Orinoco in eastern Venezuela. In the same area, work was started in 1964 on the Guri Dam facility, one of the world's largest hydroelectric power projects (see Figure 2). The first stage, with a generating capacity of 0.5 million kw, was completed in 1968 at an estimated cost of $137 million.

VENEZUELA Figure 2



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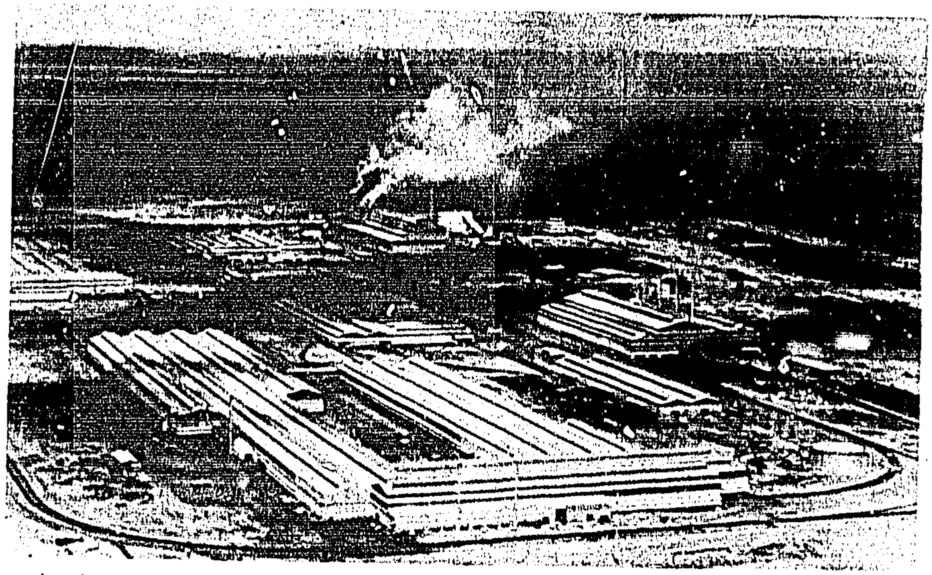
8. Private investment in manufacturing has been encouraged by preferential credits, protective tariffs, and quantitative restrictions on imports. CVF has assisted private industry mainly through low-interest loans and credit guarantees. The loans, amounting to about $35 million annually by the late 1960s, carry an interest rate of 8½%, compared with the 14% charged by commercial banks. Credit guarantees are issued for one to four years, with an annual service charge of 1½%. Protective duties were extended to a growing range of consumer goods produced in sufficient quantities to meet domestic demand, and many imports were subjected to licensing. In addition, the value of duty exemptions for industrial importers of raw materials, intermediate products, and capital equipment jumped from $60 million in 1960 to $220 million in 1969.

9. Responding to these incentives and opportunities, the manufacturing sector has taken major strides in replacing imports. Only 18% of the total supply of manufactured goods was imported in 1968, compared with 26% in 1960. Venezuelan enterprises can now satisfy most domestic requirements for a wide range of soft and durable consumer items. The 20% share of consumer goods supply that must still be imported consists mainly of foodstuffs, textiles, and rubber and glass products. Production of intermediate goods and capital equipment has grown much more rapidly than consumer goods -- reaching 43% of manufacturing output in 1968 -- and progress has been made in reducing dependence on foreign suppliers. Nevertheless, imports still provided 45% and 60% of Venezuela's supply of intermediate and capital goods, respectively, in 1968.

10. The most notable expansion has occurred in the chemical, paper, metal products, and machinery industries. In 1963, IVP completed the large petrochemical complex begun in 1957 at Moron, on the northern coast, and started producing fertilizers and various other products. Siderurgica del Orinoco (SIDOR), the state-owned steel plant located at Ciudad Guayana, near eastern Venezuela's extensive iron ore deposits, was completed in 1961 and represented a major addition to manufacturing capacity (see Figure 3). During its first six years, the

Figure 3



State-Owned Steel Plant at Ciudad Guayana

plant operated well below capacity and incurred losses of about $70 million. But as initial errors in technology and product mix were remedied, output increased and the facility gradually began to make a small profit despite high costs. In 1969, SIDOR produced about 711,000 metric tons of steel ingots (87% of the national total), and these were processed into various semifinished products and pipes, reinforcing rods, and barbed wire. However, Venezuela still had to obtain nearly one-half of its steel requirements abroad.

Agricultural Expansion

11. Agricultural production responded very favorably to government programs in the 1960s. Food production increased an average of about 6½% annually, or nearly twice the population growth rate, and imports dropped from 33% to 12% of the food supply. Except for wheat, some dairy products, and (occasionally) beans and corn, Venezuela is now essentially self-sufficient in staple foods. The agrarian colonization program initiated in 1960 contributed materially to agricultural expansion. Confronting the problem of an estimated 200,000 landless families at the beginning of the program, the government managed to settle some 161,000 families on their own farms by the end of 1968.

These families are gradually being integrated into the money economy; products marketed by them already represent about 15% of total farm output. The colonization program's marked success reflects both abundant government revenues during most of the 1960s and the ready availability of state-owned land, which made politically disruptive expropriations unnecessary.

Export Diversification

12. As far as export diversification is concerned, Venezuela has accomplished practically nothing even though sales of its dominant product have barely increased since 1959. With a total export value of $2.5 billion in 1969, petroleum sales made up 91% of exports -- virtually the same share as a decade earlier. Exports of iron ore, coffee, and cocoa -- the only other items of even slight significance in 1959 -- have either stagnated or declined. Sales of metal products, cement, rice, sugar, seafood, and other new items aggregated only $50 million in 1969 -- a mere 2% of total exports (see Table 1).

13. This sorry record is largely explained by an exchange rate that appreciably overvalues the bolivar. At the rate of 4.5 bolivars per US $1 (in effect since January 1964), few manufactured and agricultural products can be sold at internationally competitive prices. A recent World Bank study concluded that prices of Venezuelan manufactures in 1969 averaged at least 30% higher than world market prices.*

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* *Venezuelan prices traditionally have also been very high by Latin American standards. A United Nations study for 1962 indicated, for example, that average prices of consumer goods and services were about 63% higher in Venezuela than in Mexico, which has one of the region's strongest currencies. This difference was significantly reduced during the 1960s, because Venezuela's record of price stability was even better than Mexico's and Venezuela devalued the bolivar by 26% in 1964, whereas Mexico has not changed the peso's value since 1954. Nevertheless, Venezuelan prices in 1969 still were an estimated 40%-45% above Mexican prices.*

Table 1

Venezuela: Composition of Exports

Million US $

	1959	1966	1967	1968	1969 Provisional
Crude oil and petroleum products	2,160	2,215	2,334	2,356	2,306
Other traditional exports	162	145	139	118	151
Iron ore	128	124	118	103	130
Coffee	25	14	14	7	14
Cocoa	9	7	7	8	7
Nontraditional exports	5	26	46	49	50
Steel bars and ingots	0	3	11	13	14
Aluminum	0	0	0	3	5
Cement	Negl.	2	2	1	2
Rice	0	5	8	5	1
Seafood	Negl.	2	4	4	5
Sugar	0	3	4	6	4
Other	5	11	17	17	19
Reexports	28	12	15	14	16
Total	*2,355*	*2,398*	*2,534*	*2,537*	*2,523*

14. Currency overvaluation has not been an outgrowth of rapid inflation, as in many South American countries, but rather of Venezuelan policy regarding the petroleum industry. By maintaining artificially high exchange rates, Venezuelan administrations have increased the dollar cost of the oil companies' purchases of bolivars to meet local costs. Foreign exchange reserves thus benefited directly and immediately. Currency overvaluation also is partly the result of the upward pressure that petroleum exploitation has exerted on wage rates and, consequently, on production costs. Wages in the oil industry, where labor productivity is several times as large as in the rest of the economy, have been relatively high and have helped to raise wages elsewhere in industry. At the same time, the abundant revenues generated by petroleum exports allowed the government to ignore the uncompetitiveness of most other products at the prevailing exchange rate.

15. In opting for exchange rates that would enhance dollar receipts from oil development, the government in effect focused economic diversification on import replacement. Currency overvaluation made high tariffs and quantitative restrictions on imports desirable because they would help to hold import demand at a reasonable level. Over the years, a strongly protectionist atmosphere has developed, with manufacturers being content to produce on a small scale, with high costs and broad profit margins, for the captive domestic market. According to one estimate, Venezuelan manufacturers now operate on profit margins about twice as large as those in the United States or in South Korea, which is one of the most successful exporters of manufactures among less developed countries. Strong protectionist sentiment in the manufacturing sector largely explains why Venezuela finally elected not to become a full member of the Andean Common Market grouping but

has been commercial banks that charge interest rates nearly double those in major exporting countries. Export credit from government agencies totaled only $3 million in 1969, the same as in 1963. Moreover, these credits are available only for capital goods exports and are restricted to sales to Latin American Free Trade Association (LAFTA) countries. In addition, the government has been much less generous in granting import duty exemptions for export industries than for import substitution industries.

General Economic Impact

17. Although diversification has been beneficial, Venezuela has failed to realize its primary goal of restoring high growth rates. The most impressive accomplishment was in agriculture, where colonization programs and production incentives raised the average growth rate from 5% in the 1950s to 6% in the 1960s. Import substitution in manufacturing did not prevent a sharp decline in growth rates, from an average of 10% in 1951-59 to 6% in 1960-70. It thus was not possible to offset sluggish expansion in the oil industry, and overall economic growth in 1960-70 was only two-thirds as rapid as during the previous decade, as the following tabulation shows:

	Average Annual Increase (Percent)	
	1951-59	1960-70
Petroleum sector	7	2½
Nonpetroleum sectors	7½	6
Of which:		
Agriculture	5	6
Manufacturing	10	6
Gross domestic product	8	5½

Reduced dependence on the oil sector (which generated 22% of GDP in 1970 compared with 29% in 1959) clearly was much more the result of its slower growth than of accelerated advances elsewhere.

18. Inability to spur economic growth gradually weakened the government's financial position and led to expenditure restraints in 1970. Expenditures grew an average of 7½% annually in 1966-69, mainly because outlays for education, health, housing, roads, and urban facilities rose rapidly. Although taxes on the petroleum industry's profits were increased, government revenue gains averaged only 5% annually. The budget deficit consequently jumped from 1% of expenditures in 1966 to 4% in 1968 and 11% in 1969.

19. The balance of payments absorbed the impact of sluggish petroleum activity without great strain during the 1960s, but large deficits were avoided in 1969-70 only because the government borrowed $185 million from foreign commercial banks to help cover its budget deficit. With exports stagnating and imports climbing fairly rapidly after controls were relaxed in 1963, the trade surplus fell from $1.2 billion in 1960 to $800 million in 1970. Because service transactions recently have been producing deficits of some $1.2 billion annually -- about two-thirds of which represents profit repatriation by petroleum companies -- Venezuela's traditionally large current account surplus gave way to deficits of $230 million in 1968, $260 million in 1969, and perhaps $300 million in 1970. Foreign exchange reserves nevertheless have increased in recent years because of the government's borrowing, receipt of $47 million in special drawing rights from the International Monetary Fund in 1970, renewed net inflows of petroleum investment since 1967, and increased foreign aid and private investment outside the oil industry. At the close of 1970, foreign exchange reserves totaled $1 billion -- the highest level since 1959 and enough to pay for seven months' imports.

New Directions Under the Caldera Government

20. The Caldera government, in power since March 1969, is moving on several economic fronts -- trying to foster diversification, squeezing more

money out of the oil companies, and starting a new petroleum exploitation program. Growing budget strains since 1967 and reluctance to tax Venezuelans more heavily encouraged new demands on the companies' oil profits late in 1970. The timing was excellent because of the sellers' market in international oil and the assertive, unified position recently taken by the main petroleum exporting countries in bargaining for higher profit shares. By raising the income tax rate on oil companies from 52% to 60% and substantially boosting the reference values used in calculating income taxes, the government has made possible a more stimulative budget. Because the tax increase is retroactive to January 1970, revenues will jump about $440 million, or 20%, in 1971. Tax revenues from petroleum will drop in 1972 but still should be about 15% higher than in 1970.

21. Before it grabbed for more oil profits and announced its intention to reserve natural gas development to the state, the government seemed close to finalizing several service contracts, an arrangement under which private firms are to join the state oil corporation in developing new concessions.* Formal signing of the contracts has been delayed, however, and there is some question of whether all three of the foreign companies that submitted winning bids will want to go ahead promptly with the investments, estimated to total about $200 million initially. Sizable new petroleum investments are needed if Venezuela is to achieve any significant growth in oil production during the next five years. In two other problem areas bearing on petroleum exports, Venezuela already has made gains that will help to make economic diversification less urgent. Concerted diplomatic efforts brought Venezuela a larger oil import quota for the US market in 1970 and an additional small increase in 1971, even though they did not induce Washington to give it perferential access. Completion of two desulfurization plants should protect part of the large US market for Venezuelan fuel oil despite the concern over air pollution.

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22. In manufacturing, development strategy for the early 1970s has focused on two industries believed to have considerable export potential -- petrochemicals and metals. Although its fertilizer and basic chemical plants have not been financially successful so far, the state-owned IVP has started developing another large petrochemical complex at El Tablazo, on Lake Maracaibo's eastern shore. Work already has begun on two of the ten plants scheduled to be completed during the next several years at a cost of some $625 million, including infrastructure (see Table 2). IVP and CVP (the state petroleum corporation) will have 100% ownership of several facilities and enter joint ventures with US and other private investors for the others. Although Caldera apparently has reservations about the adequacy of financing plans, he is heavily committed to the project and won congressional approval in August 1970 for a $230 million appropriation for 1970-73. Petrochemicals are a logical field for Venezuelan diversification, but even projects of this scope can contribute only moderately to the country's present large export revenues.

23. Major expansion also is planned for the metals industry, including enlargement of SIDOR's present steelmaking capacity of some 1 million tons annually and addition of a flat products mill. Venezuela hopes to replace more steel imports and to raise steel exports, partly by shifting from semifinished products to higher valued items. If the capacity of the country's only aluminum plant is doubled (to 45,000 tons of ingots) by 1972, as planned, it also should be able to make a small contribution to export earnings.

Prospects

24. Economic diversification cannot help much in restoring sustained high growth rates during the next several years. Import substitution opportunities will be more limited and more costly than before; land colonization appears to be entering a period of consolidation and seems unlikely to accelerate; considerable time and money and some policy changes are needed to develop significant new export industries. Questions remain about

Table 2

Venezuela: Prospective Petrochemical Investments at El Tablazo

	Scheduled Cost (Million US $)	Ownership (Percent)	Scheduled Completion Date
Facilities under construction			
Ammonia-urea plant	115	IVP, 50; International Development Investors, 40; Colombian capital, 10	June 1971-June 1972 for different stages
Polystyrene plant	6	IVP, 40; Venezuelan private investors, 40; contracting firm, 20	Late 1972
Proposed facilities			
Aromatics plant	110	CVP/IVP, 51; private investors, 49	1974
Caustic soda and chlorine plant	30	IVP, 100	1973

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Table 2

Venezuela: Prospective Petrochemical Investments at El Tablazo
(Continued)

	Scheduled Cost (Million US $)	Ownership (Percent)	Scheduled Completion Date
Isopropanol plant	22	IVP, majority equity; unspecified international firm, remainder	June 1973
Natural gas liquid extraction plant	7	CVP, 100	Early 1973
Olefins plant	80	IVP, 100	1973
Polyethylene plant	24	IVP, majority equity; remainder unspecified	1973
Polyvinyl chloride plant	13	IVP, 50; B.F. Goodrich, 50	1972
Synthetic rubber plant	65	IVP, 51; Ashland Chemical Co., 49	March 1973
Total plant cost	472		
Infrastructure cost	153		
Total cost	*625*		

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Venezuela's ability to compete in international markets, especially if the government maintains an overvalued currency without compensating export subsidies and other promotional measures.

25. This is not to say, however, that more rapid economic advance is necessarily beyond reach. For a time, the oil industry itself offers promise of stimulating the economy -- first, by supporting larger public expenditures under the government's new tax rules and, second, by attracting new foreign capital into the industry and eventually building a larger oil export capability. Whether this latter prospect will be realized depends mainly on the oil companies' reaction to the latest tax squeeze and the prospect that natural gas resources will be partly nationalized. Unless new oilfields are developed, output probably will decline by the mid-1970s because some of the present fields are beginning to peter out.

26. If present plans for broadening manufacturing and giving the oil industry new impetus can be realized, Venezuela probably will be able to improve upon the 5½% growth rate of the past decade. The 8% rate of the 1950s, however, almost certainly will be well beyond reach. Although imports are likely to rise more rapidly than exports, reducing the traditionally large trade surplus, no major balance-of-payments problems are in prospect. Foreign exchange reserves are substantial, and capital inflows should be sizable even if the oil companies move cautiously under the service contracts. Even more than general economic growth and the foreign payments position, government expenditure trends will depend on the course of oil development rather than on diversification programs.

Conclusions

financial resources were not as plentiful as in earlier years. After a decade of effort, petroleum's role has been reduced -- but largely as a result of the sector's sluggish development rather than accelerated advances in other sectors. Agriculture did well in the 1960s, partly because of the colonization program, but manufacturing output expanded more slowly than before despite continuing import substitution. Unable to fully offset sluggish growth in the oil sector, the economy suffered a decline in average economic growth rates from 8% in 1951-59 to 5½% in 1960-70. One of the most conspicuous failures of the decade was the lack of progress toward diversifying exports, an outgrowth mainly of the government's maintaining an exchange rate that overvalues the bolivar.

28. Since assuming office in March 1969, the Caldera government has directed its energies toward raising new revenues, promoting diversification, and reinvigorating petroleum development. It took advantage of rise in Persian Gulf oil prices to raise petroleum taxes, an action that solved its immediate budget problems and will pave the way for increased public spending in the early 1970s. The government also awarded the first service contracts, which are vital to maintaining Venezuela's oil production capability. The winning companies, however, have deferred signing the contracts while they reevaluate the profitability of the arrangements in light of the tax increases. To establish a broader foundation for export diversification, the government is proceeding with public development of petrochemicals and metals industries. Major construction of a long-delayed petrochemical project at El Tablazo is under way, and expansion of state-owned steel and aluminum plants will soon begin.

29. Continuing diversification during the early 1970s should be beneficial to the economy, but it will not play a decisive role in restoring high growth rates. Venezuela is once again looking to petroleum to provide the main impetus for sustained growth. The oil sector's ability to do so depends mainly on attracting new foreign investment under the revised tax rules. Without increased investment to develop new oilfields, output probably

will decline. But if foreign oil companies decide that Venezuela still offers attractive opportunities and give new momentum to petroleum development, economic growth probably will accelerate, though not to the impressive level achieved in the 1950s.